Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Cedillo	Analyst:	Kimberly Pantoja	Bill Number:	AB 106
Related Bills:	See Legislative History	Telephone:	845-4786	Introduced Date:	01/16/01
		Attorney:	Patrick Kusiak	Sponsor:	California Budget Project

SUBJECT: Refundable Earned Income Credit

SUMMARY

This bill would:

- create a refundable Earned Income Credit (EIC) equal to 15% of the earned income credit allowed under federal law;
- allow the refundable EIC to reduce regular tax below tentative minimum tax (TMT) for purposes of the alternative minimum tax (AMT) calculation;
- add the refund of EIC to the state law specifying when interest starts to accrue on refunds of overpayments; and
- require the Franchise Tax Board (FTB) to train and inform employers regarding how employees may make withholding adjustments to reflect the EIC.

PURPOSE OF THE BILL

According to the author's staff, the intent of the bill is to utilize the state tax system to provide targeted assistance to low-income working households.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective upon enactment and operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are provided to address the department's technical concerns. Department staff is available to assist with amendments to resolve the implementation and policy concerns described below.

An amendment is suggested to provide appropriation language to fund the departmental costs associated with administering the proposed credit.

Board Position:			Department Director	Date
______ S	______ NA	______ NP	Gerald H. Goldberg	3/15/2001
______ SA	______ O	______ NAR		
______ N	______ OUA	___X___ PENDING		

ANALYSIS

FEDERAL/STATE LAW

Existing federal law allows eligible individuals a refundable EIC. A refundable credit allows any credit amount greater than the taxpayer's tax liability to be paid to the taxpayer. The EIC is a percentage of the taxpayer's earned income and is phased out as income increases. The percentage varies, based on whether the taxpayer has qualifying children.

The federal credit for the 2000 taxable year is determined as follows:

Eligible Individual with	Earned Income	Completely Phased-out @	Credit %	Maximum Federal Credit	Proposed State Credit
No qualifying children	$4,610	$10,380	7.65	$353	$53
1 qualifying child	$6,920	$27,413	34	$2,353	$353
2 or more qualifying children	$9,720	$31,152	40	$3,888	$583

Employees cannot claim the federal EIC if their 2000 investment income (such as interest and dividends) is more than $2,400. The amount of the federal EIC is reduced by the AMT, if any.

Existing federal law specifies that if the federal EIC is denied and the Internal Revenue Service (IRS) determines that the error was due to reckless or intentional disregard of the federal EIC rules, the EIC will not be allowed for the next two years. If the error is due to fraud, then the EIC will not be allowed for the next ten years.

Existing federal law allows an eligible individual to receive advance payment of the EIC in his or her paycheck by providing his or her employer with a Form W-5, Earned Income Credit Advance Payment Certificate. Taxpayers who receive advance payments of the EIC must file an income tax return. Any advanced payments that exceed the allowable EIC must be paid back. While EIC recipients may pay little or no income tax, allowing the EIC to be received through advance payments offsets the burden of social security and other payroll taxes.

Existing state law provides various personal credits to taxpayers that may reduce (but not below zero) their state income tax liability. Existing state law does not provide an EIC.

Under state law, individuals with income less than the filing thresholds are not required to file an income tax return since the standard deduction and personal exemption credit would eliminate any tax liability.

For 2000, these filing thresholds are $11,302 in gross income or $9,042 in adjusted gross income (AGI) for single taxpayers and $22,605 in gross income or $18,084 in AGI for married filing joint taxpayers. These thresholds are increased based on the number of dependents. These thresholds also are indexed annually for inflation.

THIS BILL

This bill would provide a refundable EIC in an amount equal to 15% of the EIC (prior to its reduction by AMT) allowed by federal law. The amount of state EIC also would be reduced by AMT, if any. Any state EIC in excess of the taxpayer's state income tax liability would be credited against other amounts due, and the balance, if any, would be refunded to the taxpayer.

This bill specifies the proposed EIC would be refunded to the taxpayer only if funds are appropriated for that purpose by the Legislature.

This bill specifies that no credit shall be allowed to any married person who files a separate return for the taxable year.

This bill specifies that the federal allowance of advanced payment of EIC provided through additional employer payments shall not apply. However, the bill would allow the individual to reduce monthly withholding to reflect the credit.

This bill would provide that any refund of the credit would be treated the same as the federal EIC in determining if an individual qualifies for benefits under Division 9 of the Welfare and Institutions Code. A federal EIC is not considered in determining if an individual qualifies for welfare. This provision does not impact the department and is not discussed in this analysis.

This bill would include the refundable EIC in the list of credits that can reduce regular tax below tentative minimum tax (TMT) for purposes of the AMT calculation.

This bill would add the refund of EIC to the Revenue and Taxation Code (R&TC) provisions specifying when interest starts to accrue on refunds of overpayments.

This bill would require the FTB to train and inform employers regarding how employees may make withholding adjustments to reflect the credit.

This bill also would eliminate the teacher retention tax credit and a prior solar energy credit from those credits reducing regular tax below TMT. The author's office has indicated that these provisions were unintentional. Amendments are provided to correct these errors and these provisions are not otherwise addressed in this analysis.

IMPLEMENTATION CONSIDERATIONS

This bill would require regular appropriations by the Legislature to pay for the refundable portion of this credit. Disallowance of the credit to some taxpayers could result if the amount of credits claimed exceeds the funds appropriated. If sufficient funds were not appropriated to cover all of the refunds due, interest would have to be paid to refund recipients. Additional contacts to the department by refund recipients would likely increase departmental costs.

Many taxpayers eligible for the federal EIC probably have little or no federal or state tax liability and do not have a California filing requirement. Some 670,000 current nonfilers would be required to file tax returns to claim the proposed EIC, which would significantly impact the department’s programs and costs.

The proposed credit under this bill would be claimed by low-income taxpayers. Low-income taxpayers generally file their tax returns on forms 540A or 540-2EZ. To minimize the complexity of these returns, the only credit allowed on these forms is the nonrefundable renters' credit. The department would not add the EIC to the 540-2EZ as this form does not accommodate attached schedules due to its size. Taxpayers that would normally file on Form 540-2EZ would be required to file Form 540A to claim the EIC.

Since the proposed credit is refundable, the credit calculation would need to be shown in the payment section on all personal income tax (PIT) returns except the Form 540-2EZ. This would increase PIT return Forms 540, 540NR, 540X, and potentially the 540A by one page. This would result in a significant impact on FTB's operations and costs. Adding a page to these returns will slow the processing of the returns and require additional storage space. The department may be required to lease additional office and file storage space; however, the department would work within available space to the extent possible.

The IRS completes tax returns for some taxpayers who claim the refundable EIC. Since the proposed California EIC would be based on a percentage of the federal EIC, these taxpayers may expect the FTB to calculate their proposed California EIC. The FTB does not have access to the federal modified adjusted gross income figures (non-taxable and taxable earned income) that are used for the federal EIC calculation. Therefore, the FTB would be required to request this information after the filing season and store additional documentation on these taxpayers. This would result in additional departmental costs and may delay issuance of refunds until the information becomes available.

Refund returns generally are filed early in the filing season. If taxpayers claiming the California EIC file late in the filing season after they receive their federal EIC, that behavior could have a major impact on the processing of returns and possibly cause delays in the issuance of refunds. The taxpayer error rate on the federal EIC and fraud concerns cause the IRS to adjust many returns. Consequently, the correct federal EIC amount may not be known until after the taxpayer has filed the state return and claimed the proposed California credit. The FTB then would have to issue an assessment to retrieve incorrect refunds. This would result in additional departmental costs.

This bill would require the FTB to provide training and information directly to employers; however, the Employment Development Department (EDD), rather than FTB, advises employers on matters relating to withholding. If such information could be provided indirectly through FTB's normal methods for providing information to tax preparers and taxpayers (i.e., instructions with tax forms, the Tax News newsletter) or through EDD advisories, this provision would not cause significant implementation issues. If this department were required to contact all employers in the state, significant resources would be required to implement this provision. Clarification is needed before the department could implement this portion of the bill.

Under specific provisions of federal law, denial of the EIC is treated as a deficiency, subject to protest and appeal. The bill does not specify protest and appeal rights in connection with denial of the proposed California EIC. It is unclear when denial of the state EIC would entitle the taxpayer to protest and appeal rights.

It is unclear if taxpayers would be ineligible for the state credit because of reckless or intentional disregard of the rules or because of fraud in claiming the state credit as provided under federal law.

TECHNICAL CONSIDERATIONS

Amendment 1 would add the refundable EIC to the state law that specifies the order in which refundable credits are allowed.

This bill strikes the teacher retention tax credit and the solar energy credit from the state law that allows credits to reduce regular tax below TMT. The author's office has indicated that it was not the intent to eliminate these credits from this list, as they are still being claimed by taxpayers. Amendment 2 would restore these credits.

Amendments 3 and 5 are provided for clarification purposes.

Amendment 4 is provided to correct a reference.

Amendments 6 through 8 are provided to remove an obsolete reference to the former refundable renters' credit.

LEGISLATIVE HISTORY

AB 1854 (Cedillo, 2000) and SB 1421 (Solis, 2000) each proposed a refundable EIC; AB 1854 failed passage in Assembly Appropriations and SB 1421 failed passage in the Senate Revenue and Taxation Committee. AB 2466 (Wiggins, 2000) proposed a nonrefundable EIC, failed passage in Assembly Revenue and Taxation Committee. AB 2490 (Wesson, 2000) and AB 1370 (Wesson, 1999) both would have required employers to notify their employees of the availability of the federal EIC, and were vetoed by the Governor. The Governor's veto message stated it is primarily the responsibility of the federal government to educate taxpayers on the federal EIC and it would be inappropriate for the State to impose this responsibility on businesses. AB 83 (Villaraigosa, 1997), AB 470 (Ducheny, 1997), and SB 43 (Solis, 1997), each proposed an EIC. AB 83 failed passage in Senate Appropriations; AB 470 and SB 43 failed passage of the first house by January 31 of the second year of the session.

PROGRAM BACKGROUND

Prior to its sunset in 1992, California law provided a nonrefundable low-income tax credit in an amount ranging from 20% to 100% of the "computational tax," as defined, based on the taxpayer's AGI. The AGI amounts were indexed annually by the FTB. The "computational tax" was defined as the regular tax less all-nonrefundable tax credits. This low-income tax credit could only be taken after all other allowable credits, except refundable credits.

OTHER STATES' INFORMATION

FTB staff gathered tax information from Massachusetts, Minnesota and New York. These states were chosen because like California they have a corporate level tax measured by income and a personal income tax. These states also use federal tax law as the starting point for calculating state taxes (this is commonly called federal conformity), but with modifications that are unique to each particular state.

Massachusetts provides a refundable personal tax EIC equal to 10% of the federal EIC, which applies to taxpayers who have earned income, who meet modified AGI thresholds, and who do not have certain disqualifying income that subjects the credit to phase out. In general, the maximum earned income for a qualified taxpayer and the related federal EIC is as follows:

For 2000

	Maximum Earned Income	Federal EIC
No qualifying children	$10,380	$353
One child	$27,413	$2,353
Two or more children	$31,152	$3,888

Minnesota provides a refundable personal tax working family credit equal to 15% of the federal EIC.

New York provides a refundable personal tax EIC equal to 20% of the federal EIC, reduced by the personal tax "household" credit.

FISCAL IMPACT

First year implementation costs are estimated at $6.5 million for fiscal year 2001-2002 and $5.3 million for fiscal year 2002-2003. Amendment 9 is provided to suggest language for an appropriation to fund these departmental costs.

The estimated costs include printing and processing returns for a large number of people who currently do not have a filing requirement but would file solely to claim the refundable EIC. The number of new filers is estimated to be 670,000 for the first year and 540,000 returns thereafter. The estimated costs also include processing refunds for an estimated 2.6 million current filers in the first year and 2.1 million thereafter who would qualify to claim the credit.

The addition of the EIC to the tax forms and instructions would cause Forms 540, 540NR, 540X, and potentially 540A to expand to another page. This additional page would significantly slow the processing of those returns, which causes the department to incur additional costs.

The credit is based on the allowance of the credit at the federal level. It is not possible for the department, during processing of the state return, to determine if the federal credit was allowed. To avoid the risk of paying interest on the refund created by the credit, the FTB would be required to calculate the amount of the federal credit and then apply 15% for state purposes. Computer processing systems would have to be modified to calculate the federal credit.

Other costs include changes to the computer systems, increased taxpayer phone calls and correspondence, and electronic and paper storage.

Significant costs may be generated if the department has to collect erroneously issued refunds due to fraud or federal EIC adjustments.

An undetermined number of fraud investigators would be required to verify this credit. Costs have not been determined at this time.

Departmental costs associated with providing training and information to employers cannot be determined until this provision has been clarified.

ECONOMIC IMPACT

Tax Revenue Estimate

This proposal is estimated to impact PIT revenue as shown in the following table.

Fiscal Year Cash Flow Taxable Years Beginning After December 31, 2000 Enactment Assumed After June 30, 2001 $ Millions		
2001-02	2002-03	2003-04
-$605	-$615	-$630

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The revenue impact for this bill will be determined by the number of qualifying taxpayers and the amount of earned income on which the credit is based.

These estimates were derived from the Department's Personal Income Tax Model and grown by the U. S. Treasury growth rates specifically for the federal earned income credit.

SUPPORT/OPPOSITION

Support: California Budget Project (sponsor)
Western Center on Law and Poverty
California Tax Reform Association
National Economic Development & Law Center
Mexican American Legal Defense and Education Fund
Children's Advocacy Institute
California Church
Jericho
California Catholic Conference

Opposition: None on file.

ARGUMENTS/POLICY CONCERNS

The IRS has experienced a significant number of invalid and fraudulent returns with the refundable federal EIC. According to the Financial Audit Report to the Secretary of the Treasury for Fiscal Year 1999, of the 573,000 tax returns claiming $1.25 billion in federal EIC (chosen through a screening process of 19.8 million EIC claims), $1.08 billion (86%) were invalid.

This bill does not specify a repeal date. Credits typically are enacted with a repeal date to allow the Legislature to review the effectiveness of the credit.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 106
As Introduced January 16, 2001

AMENDMENT 1

On page 2, line 29, after "Sections" insert:

17052.1 (relating to earned income credit),

AMENDMENT 2

On page 3, strike lines 5 through 12 and insert:

(B) The credit allowed by Section 17052.2 (relating to teacher retention tax credit).
(C) The credit allowed by former Section 17052.4 (relating to solar energy).
(D) The credit allowed by former Section 17052.5 (relating to solar energy, repealed as of January 1, 1987).
(E) The credit allowed by former Section 17052.5 (relating to solar energy, repealed as of December 1, 1994).
(F) The credit allowed by Section 17052.12 (relating to research expenses).

@@@@@@@@@@@@@@@ Leg Counsel: Renumber subsequent subparagraphs. @@@@@@@@@@@@@@@

AMENDMENT 3

On page 6, line 14, strike "for purposes of federal income tax"

AMENDMENT 4

On page 6, line 15, strike "subdivision" and insert:

subsection

AMENDMENT 5

On page 6, line 17, after "tax" and before "." insert:

, for federal income tax purposes for the same taxable year

AMENDMENT 6

On page 7, line 15, after "Section 17052.1" strike "or"

AMENDMENT 7

On page 7, line 16, strike "subdivision (j) of Section 17053.5"

AMENDMENT 8

On page 7, line 31, strike "or subdivision (j) of Section 17053.5"

AMENDMENT 9

On page 8, line 9, following “SEC. 5” insert:

(a) There is hereby appropriated from the General Fund for expenditure in the 2001-2002 fiscal year the sum of six million five hundred thousand dollars ($6,500,000) for allocation to the Franchise Tax Board in augmentation of Item 1730-001-0001 of the Budget Act of 2001.

(b) Any funds that are allocated pursuant to subdivision (a) shall be expended by the Franchise Tax Board solely for the purposes of implementation and administration of the Refundable Earned Income Credit under Section 17052.1 of the Revenue and Taxation Code.

SEC. 6.